BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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Annual Compliance Report, 2014   )   Docket No. ACR2014

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INITIAL COMMENTS OF THE
AMERICAN CATALOG MAILERS ASSOCIATION

(February 2, 2015)

Pursuant to Commission Order No. 2313 (Dec. 31, 2014), the American Catalog Mailers Association (ACMA) is pleased to submit these comments, with supporting file ACMA_ACR2014_Workbook.xlsx.[1]

By pairing bulk purchasing (or self-supply) and logistics strength, catalogs have become a valued source of goods and services, many of which are otherwise difficult to find. They provide information and serve as resource documents. They are a major component of the Standard Mail class, and they are linked to other mail categories. On average, catalogers spend over half of their marketing budgets on postage.[2] Rates for sending catalogs, then, are critically important to catalogers and catalog recipients.

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[1]   Unless otherwise indicated, all reference herein to 'tabs' are to this workbook.

[2]   An ACMA unpublished Survey of Member Mail Use, 2012, showed 54%, a figure members have told us has increased since.

Generally, catalogs are classified as flats. A minority is sent via <u>Standard Flats</u> (SF), a category that includes a considerable amount of Nonprofit. A majority is sent via <u>Carrier Route</u> (CR), another category that includes Nonprofit, as well as a few letters and parcels. A small share is sent via <u>High-Density and Saturation Flats and Parcels</u> (HD), which also contains Nonprofit, along with Total Market Coverage mailings, a large volume of Saturation mail, and some parcels. The fact that catalogs are spread among three categories, particularly categories with disparate content, makes it difficult to review catalog rates and to estimate the costs they incur.

The difficulty became more pronounced when "with Docket No. R2013-10" the Postal Service "required FSS preparation for all flat-shaped mail pieces destinating in FSS zones[,] preparation [that] had previously been optional."[3] And the CPI adjustments proposed in Docket No. R2015-4 will blur further the distinctions among these categories, as it appears that CR (though maybe not HD[4]) destined to FSS zones will be moved to the SF category and intermeshed with other FSS mail, consistent with FSS schemes. This will make the category boundaries less meaningful, as co-mailing has also done, but will not reduce the disparity within them. We focus on SF and CR because costs and cost coverages for them are reported separately.

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[3]   Docket No. R2015-4, Notice at 14. It appears these pieces shifted to what is essentially the 5-digit category of SF, but continued to pay CR rates. We do not see data and category-definition matters associated with this shift to be non-issues, even if, in a sequel to its "Filing [of] Partial Supplemental Information" (Jan. 15, 2015), the Postal Service clarifies things further and files revised analyses.

[4]   In the R2015-4 docket, in response to CHIR No. 1, Question 2, the Postal Service states that "FSS preparation for Standard Mail High Density, High Density Plus, or Saturation remains optional."

Six sections follow. The first deals with catalog rates and the coverages as reported. The second reviews the ACMA cost index and uses it to help analyze cost levels. The third, fourth, and fifth look at the behavior of mail processing costs, city carrier street costs, and city carrier in-office costs, respectively. The sixth is a conclusion.

I. APPROPRIATELY VIEWED, THE RATES FOR CATALOGS COVER THEIR COSTS, EVEN IF COMBINED WITH NONPROFIT. THE POSTAL SERVICE SHOULD BE ALLOWED FLEXIBILITY TO MANAGE ASSOCIATED RATESETTING.

Several past proceedings have addressed the cost coverages of Standard Flats, Carrier Route, and High-Density, reported in this docket, in order, to be 81.6%, 140.2%, and 227.6%. These coverages, however, even if reliable, and we argue in sections further on that they are not, do not relate in a meaningful way to the rates for catalogs.

A starting point for reviewing catalog rates would be to note that the joint cost coverage for the *Commercial* categories of Standard Flats and Carrier Route is 114.6%, up from 114.0% in 2013 and 107.9% in 2012.[5] And these coverages would be even higher if: (a) it were recognized that the current rates were in effect for only about two-thirds of the year, (b) the high cost coverage of High-Density were factored in, and (c) the costs developed for the Nonprofit categories recognized that, as we believe to be the case, Nonprofit tends in greater degree than Commercial to be submitted in sacks. Therefore, the cost coverage of Commercial catalogs is something greater that 114.6%,

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[5]   Information relating to Nonprofit cost coverages is contained USPS Lib. Ref. 27, filed with each Compliance Report.

supporting statements of some Postal Service officials to ACMA that catalogs are viewed as a profitable segment of the mail.

Underlying these cost coverages are rates for an assembly of categories, the two largest being 5-digit automation and Carrier Route. Looking at mail processing and carrier costs only, the per-piece cost of 5-digit automation is estimated at 41.39 cents and of Carrier Route at 17.61 cents.[6] The difference between these two costs is 23.78 cents. However, the *rate difference* between the categories is only 9.1 cents.

ACMA understands that the Postal Service could, while staying at the price cap, decrease the rates for Carrier Route and increase the rates for 5-digit automation et assoc., consistent with recognizing more of the 23.78-cent cost difference. Such an adjustment could result in cost coverages of over 100% for both Standard Flats and Carrier Route, even were the Nonprofit categories to be included. Our members would be split on whether this helped them. But we also see that such an adjustment might be ill-advised.

The reasons that such an adjustment might be ill-advised are several: (1) as we explain in Sections II through V, there are good reasons for doubting the validity of the costs that might appear to support such a change; (2) as a practical matter, such a change would bring about decisions to stop mailing or to increase co-mailing, to an extent that the Postal Service would, for all intents and purposes, be stripped of Standard Flats mail;[7] and (3) imposing such a realignment on SF and CR would thwart

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[6]   Cost figures taken from USPS Lib. Refs. 11 (USPS-FY14-11STD_flats.xlsx), 18 (FY14 ECR Unit Costs.xlsx), and 19 (UDCmodel14.xlsx).

[7]   The co-mail question is one indicator of a problem. The costs (41.39 cents for 5-d automation pieces and 17.61 cents for Carrier Route pieces, for a difference of 23.8 cents) *** footnote continued next page

and likely make impossible the steps toward FSS rates being taken by the Postal

Service in the R2015-4 filing. Under these circumstances, we believe that the current

rates for SF, and specifically those for the Commercial category, should not be viewed

as in any way out of compliance with the law and that the Postal Service should be

given latitude to manage associated ratesetting.

II. INORDINATE AND INEXPLICABLE INCREASES IN THE COSTS OF THE FLATS PRODUCTS RAISE SERIOUS QUESTIONS ABOUT THEIR VALIDITY. THESE QUESTIONS MUST BE ADDRESSED.

Average unit costs of categories are obtained routinely by dividing their costs by

their volumes. But trends in average unit costs are misleading indicators of cost levels,

because they are influenced by changes in product mix. Mix influences can be

removed by developing weighted indexes of *elemental* unit costs. In a form familiar due

to its appearance in price indexes, the most obvious weighted index would be:

$$\frac{\sum_{i=1}^{I}(V_{i,1} \; x \; UC_{i,2})}{\sum_{i=1}^{I}(V_{i,1} \; x \; UC_{i,1})} \qquad \text{Equation 1}$$

$UC_{i,j}$ is the unit cost of elemental processing activity i of I, in period j. The

weights, $V_{i,1}$, the same in the numerator and denominator, are the corresponding period-

1 volumes. A result of 1.05 would mean that the average unit cost, with mix effects

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footnote continued

show that the Postal Service saves 23.8 cents on each piece that moves from 5-digit automation to Carrier Route. We believe this savings is not indicative, and we doubt that anyone at the Postal Service believes it is.

removed, was 5% higher in period 2 than in period 1. It would be common to peg the

index at 100 in period 1 and say the level of unit cost in period 2 was 105.[8]

It can be shown relatively easily that Equation 1 is identically equal to:[9]

$$\frac{\dfrac{TC_2}{TC_1}}{\dfrac{\sum_{i=1}^{I}(UC_{i,2} \; x \; V_{i,2})}{\sum_{i=1}^{I}(UC_{i,2} \; x \; V_{i,1})}}$$

Equation 2

The numerator is a ratio of the two attributable costs. The subscripts on V and UC are

different from corresponding ones in Equation 1, making the denominator a *cost-weighted quantity index*.

Developing a cost-weighted quantity index is a considerable undertaking. But,

ACMA showed in the Appendix to its Comments in Docket No. ACR2011 that an index

of the quotients obtained by dividing the price index by the associated cost coverages,

all of which are readily available, is a cost index of the following form:

$$\frac{\dfrac{TC_2}{TC_1}}{\dfrac{\sum_{i=1}^{I}(P_{i,2} \; x \; V_{i,2})}{\sum_{i=1}^{I}(P_{i,2} \; x \; V_{i,1})}}$$

Equation 3

P_i is the price for rate cell i. Equation 3, calculated from the quotients, is referred to

herein as the ACMA cost index. It differs from Equation 2 only in that its denominator is

a *price*-weighted quantity index.

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[8]   An index is designed to quantify the magnitude of the increase in a measure, like the unit cost of a category, not to state the level of the unit cost at any specific point in time.

[9]   For the steps involved in showing this equality, *see* Comments of ACMA, Doc. No. R2013-10, Oct. 17, 2013, App., pp. 3-5 esp.

A total-cost ratio deflated by a weighted quantity index is always a cost index. One can debate the merits of cost-weighted (Equation 2) vs. price-weighted (Equation 3) quantity indexes.[10] Both have legitimacy. To see the effect of the difference here, ACMA developed a cost-weighted index in Docket No. R2013-1 and showed that it differs in negligible degree from the price-weighted index implicit in the ACMA cost index.[11] Therefore, the ACMA cost index gives approximately the same results as using Equation 1, and the data for the ACMA index are readily available. The happy result is that, using the ACMA formulation, cost indexes can be constructed easily.

Graph 1 shows ACMA cost indexes for Standard Flats, Carrier Route, Outside County Periodicals, and Standard Letters. Also shown is a factor price index.[12] The base year is FY 1998, except that, due to limited data, the Carrier Route index is pegged to the Standard Flats index in 2008. The Periodicals index is included because Periodicals is a related flats category. Also, Periodicals has been a well-defined category, with data developed and reported accordingly, for a longer period than

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[10] For a discussion of the merits of the two indexes, *see* Comments of ACMA, Nov. 1, 2012, Doc. No. R2013-1, App. II, p. 11, incl. fn. 9, and Comments of ACMA, Oct. 17, 2013, Doc. No. R2013-10, App., pp. 7-8.

[11] As explained in the text, the ACMA cost index is calculated from the quotients of the price index divided by the associated cost coverages. Once the ACMA cost index is calculated, it can be set equal to Equation 3. The numerator of Equation 3 is easily calculable. Solving for the denominator gives the price-weighted quantity index that is implicit in the ACMA cost index. See tabs '5-Std Quant' and '9-Graph-9'. Graph 9 has not been updated to FY 2014.

For a showing that the two quantity indexes differ in negligible degree, *see* Comments of ACMA, Nov. 1, 2012, Doc. No. R2013-1, pp. 8-9, incl. Graph 2, and Comments of ACMA, Oct. 17, 2013, Doc. No R2013-10, App., pp. 9-10, incl. Graph 2.

[12] *See* tabs '1-Factor P', '2-Std Ltr', '3-SF', '4-CR Std', '4.5 Per', and '8-Graph-1'. The factor price index is taken from the Postal Service's TFP analysis, filed annually.

Standard Flats. The Standard Letters index is included for comparison purposes.

Graph 1
Cost Index Standard Flats,
Cost Index Standard Letters,
w/ Factor Price Index
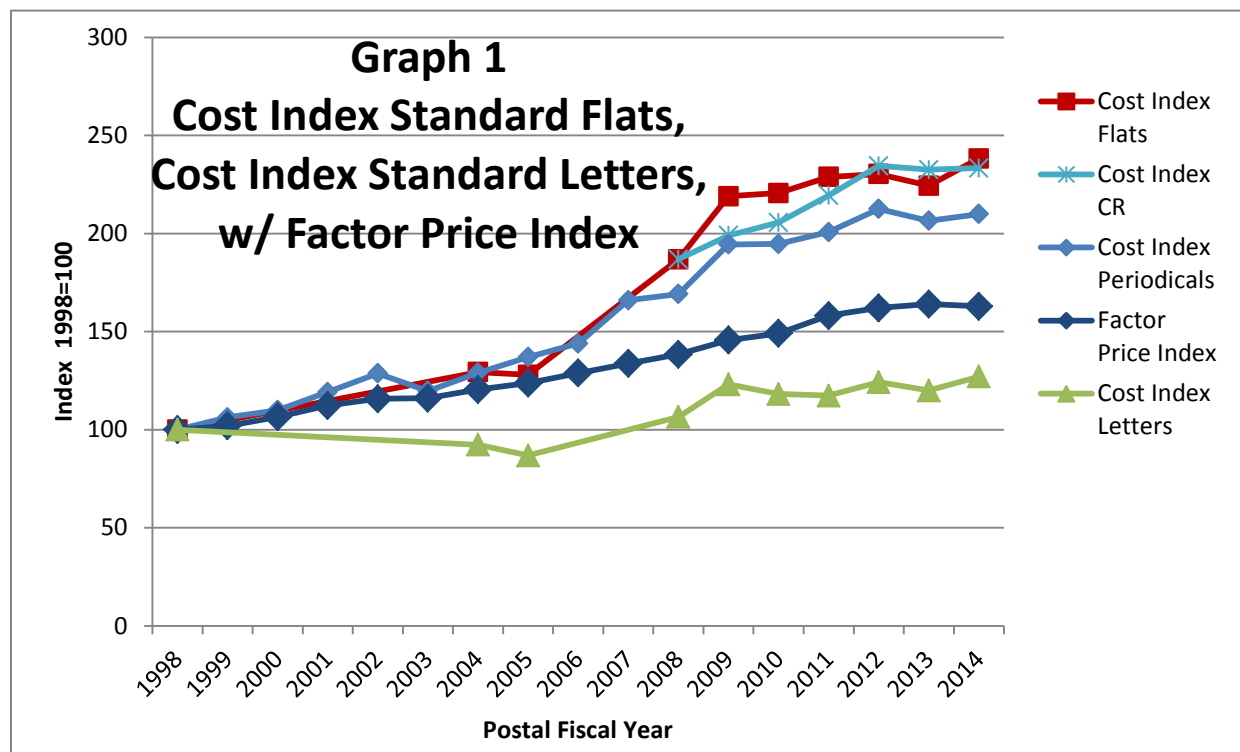
Several observations may be made.

1. Though factor prices increased 62.9%, Letters costs increased only 27.1%. Relatively, then, the cost of Letters decreased about 35.8 points. This decrease is consistent with increases in DPS rates, improvements in mail preparation by mailers, and increases in the efficiency of the automation equipment.

2. Periodicals costs increased 109.9%, much more than factor prices. Given improvements in mail preparation and mail processing, which should have helped to hold costs down, 109.9% comes off as seriously out of bounds.

To see the effect of using a cost index instead of raw unit costs, tab '4.5 Per' shows that the unindexed unit costs increased only 65.6%. The ACMA index, at 109.9%, is almost double that.[13]

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[13]   A few other comparisons are interesting. In CHIR No. 2, Q7, the Commission noted a 19.10% increase in mail processing costs for Outside County Periodicals from 2007 to 2014, which the Postal Service corrected on Response (Jan. 29, 2015) to be 10.36%. The Postal Service pointed out that the clerk wage index increased 12.4%, about the same as ACMA found on tab '3.5-MP SF' cell S26. The ACMA cost index over this period (covering *all* Periodicals costs), which corrects for mix changes, shows an increase of 26.5% (tab '4.5 Per' cell Y26), well
*** footnote continued next page

3. Standard Flats costs were up 138.3%, 2014 being 6.2% above 2013. The costs for Carrier Route moved somewhat with Standard Flats. These increases mirror those of Periodicals, except they are larger.

4. The cost coverages depend not only on the cost outcomes, but also on the rate increases and the Nonprofit proportions. In the case of Standard Flats in 2014, for example, the costs increased 6.2% and the rates, annualized, increased about 4.2%. This would have led to a 2 point decrease in coverage, approximately. But, the Nonprofit proportion increased from 21.7% to 22.6%. The net result was a 3.3 point decrease in coverage.

Carrier Route came out different. Its costs increased only 0.3%. With a rate increase of 4.2%, this would have led to an increase in coverage of about 3.9 points. But its Nonprofit volume decreased 26.8%, reducing the Nonprofit proportion from 9.1% in 2013 to 7.1% in 2014. With this factored in, the cost coverage increased 6.9 points. Roughly, the relative decline in Nonprofit volume added about 3 points to the cost coverage.

Several factors could play into explaining these outcomes. First, the volume declines could have led to excess capacity. Second, whether or not there is excess capacity, the costing systems could be generating costs that do not relate well to the behavior of operations, meaning they are above marginal. Third, some scale economies could have been lost, though one would not expect a long-run marginal cost curve sloping upward toward the vertical axis to account for cost increases of this magnitude. Specifically, the increase in the costs of Standard Flats was above the increase of factor prices in the amount of 75.4 percentage points plus the cost-reducing effects of all improvements over the period in mail preparation and mail processing.

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footnote continued

above the wage increase. Although the categories compared here are not fully aligned, it is clear that the cost increase was well above the factor price increase.

Matters involved in the second and third of these factors are discussed further in the following three sections.

III. THE HIGH VARIABILITY OF MAIL PROCESSING COSTS ARGUES THAT, ON A UNIT BASIS, THEY SHOULD NOT INCREASE IN THE FACE OF VOLUME DECLINES. THEREFORE, IF VOLUME DECLINES ARE TAKEN AS AN EXPLANATION FOR THE UNIT COST INCREASES, THE COST RESULTS MUST BE CONSIDERED INVALID.

Mail processing costs are developed consistent with marginal principles and are tailored to be long-run in nature. In the analysis, their variability is taken to be near 100%, implying that no fixity exists in the costs and that scale economies are not available. If this variability is correct, unit mail processing costs, deflated by the factor prices underlying them (in this case clerk wage rates), would be expected to decline to the extent of improvements in mail preparation and mail processing.

Over half the costs of Standard Flats are for mail processing, and over half of those are for automation-qualified pieces that are presorted to the 5-digit level. This is a relatively homogeneous category, not affected significantly by changes in mix, and it is a category for which data are available. Therefore, trends in it can be examined without the use of a weighted index.

Graph 2 shows an index of the deflated unit mail processing costs for 5-digit automation flats, 1998 = 100.[14] The points for 1998, 2001, and 2003 are for *3/5-digit*

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[14] *See* tab '3.5-MP SF'. Test Years are used for 1998 (Doc. No. R97-1), 2001 (Doc. No. R2000-1), 2003 (Doc. No. R2001-1), and 2006 (Doc. No. R2005-1). Years 2007-2014 are from reports under the new law, using the same analysis as in the earlier years. Test Years are detailed, systematic projections of Base Years, which are actual outcomes. When Test Years arrive, actual costs developed for them can be different from the projections. The actual costs then become the Base Year for another Test Year. Differences between projected Test Years and actual outcomes, then, have only a short-term effect—they do not affect longer-term trends.

presort, which is mostly 5-digit, making the index since those years an understatement, but not a large understatement. Well-known volume reductions occurred after 2007.

Graph 2, Deflated Mail Processing Costs for 5-d Automation Flats
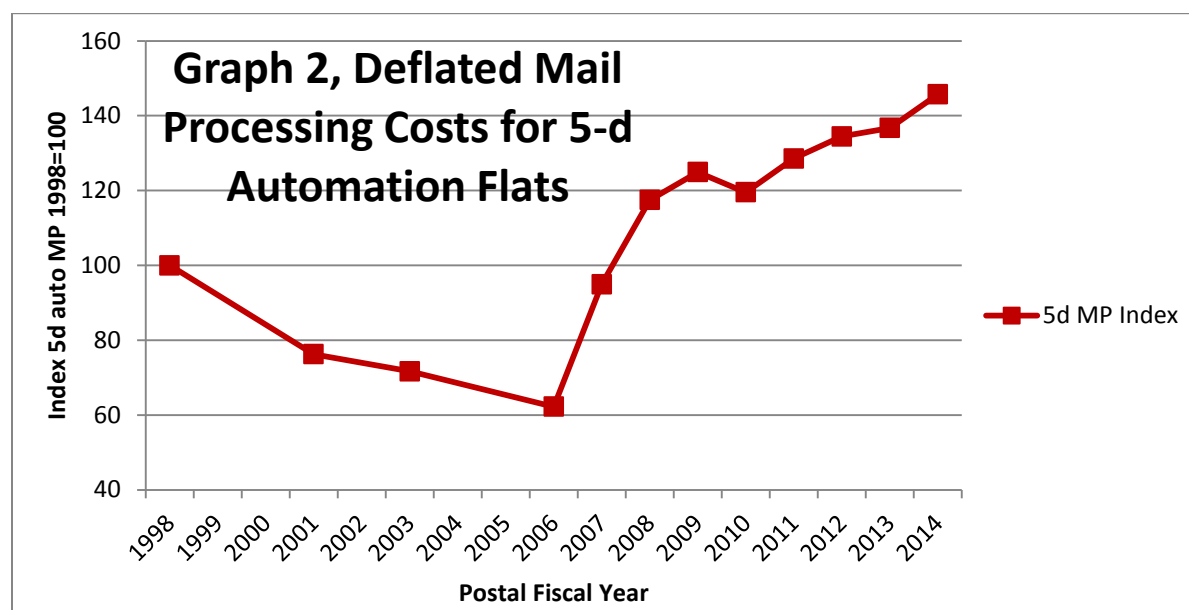
In line with expectations, unit mail processing costs declined from 1998 through 2006, perhaps too much. Since 2006, however, the costs have increased sharply, and this occurred during a period in which improvements in mail preparation and mail processing are known to have occurred. Over the entire period shown, unit mail processing costs increased 45.7% (notably, this is just 0.5 percentage points above the ACMA cost index for *all* Standard Flats costs when the ACMA index is deflated by the factor price index—*see* 'tab 3-SF' cell N26). How does one explain increases of this magnitude?

For the overall increase of 45.7%, five possible explanations exist. (1) The costing methods could have changed, but a review of them shows that this effect was

small. (2) Volume shifting to the FSS could increase these mail processing costs.[15] (3)

The actual variabilities could be considerably below 100%, suggesting scale

diseconomies and making the costing results invalid. And note that if the variabilities

are below 100%, the question of how the variability percentages change with volume

must be faced. We know of no analysis of this question.[16] (4) Persistent and still

growing amounts of excess capacity could exist in flats processing. (5) The inherent

costs of Postal operations could be increasing due to things akin to environmental

constraints. For example, the Postal Service could be tabbing flats, coating pieces to

increase rigidity, treating pieces to aid biodegradation, binding edges to reduce paper

cuts, and slowing machines to reduce noise. If any such things are happening, they

need to be identified and considered carefully. We know of no such things.

The effect of FSS processing likely contributed to the increase in 2013 and to the

much larger increase in 2014. Looking at the overall period, however, it seems likely

that costs of excess capacity are being attributed or that the variabilities are lower than

assumed, or both. The costs being reported, then, are questionable, and they cannot

be considered to be efficiently incurred. This means (a) that conclusions concerning

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[15]   In its FY 2013 Compliance Report (at 23), the Postal Service noted the decline in 2010 and explained it as due to "network improvements" allowing "the increased usage of mechanized equipment." As shown in the graph, this decline more than reversed itself in 2011.

[16]   It seems unlikely that a productive operation would have the special characteristic of a variability percent that is constant in the face of volume changes. Indeed, a graph of percent variability vs. volume, which need not be a straight line, could have an infinite number of shapes and slopes. Being horizontal at a constant level is just one of them, so the chances are one in infinity, meaning zero. It might be argued that taking the marginal cost to be constant, *ceteris paribus*, is also one possibility among many, but it is altogether possible that an understanding of an operation involving people, productivities, and stable machine speeds could support a belief that a marginal cost is constant. Certainly some evidence would be needed to support any assumption taken.

how costs would respond to volume changes cannot be reached and (b) that the cost

coverages are invalid.

IV. THE LARGE, PERSISTENT INCREASES IN IMPLICIT MARGINAL TIMES (ADDITIONAL TIME PER ADDITIONAL PIECE) FOR THE STREET ACTIVITIES OF CITY CARRIERS SUGGESTS SERIOUS PROBLEMS WITH THE COSTING SYSTEM.

City carrier street costs account for a little over 15% of the costs attributed to the

Standard class, and in-office costs account for another 12%.[17] The analysis of street

costs develops a relationship between street time and several categories of volume.

Partial derivatives then provide estimates of marginal times, which are additional

seconds per additional piece. Multiplying these by wage rates gives marginal costs.

Inversely, marginal costs (which are reported regularly) can be deflated by wage rates

to obtain the marginal times. These times are estimates of the behavior of street

operations.

For mounted routes, a marginal time would be for carrying an additional piece in

a tray to a truck, moving the tray a stop sooner to the carrier's side, and thumbing

through an additional piece at the stop. The need to fold the pieces together and insert

them into the box would not change. During 2004-2008, the marginal times for

Standard Flats, Carrier Route, Periodicals, and Standard Letters ranged from 2.03

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[17]   Figures developed from USPS Lib. Ref. 2, tab 'CSSummary'. The cost of *rural* carriers is about 9.4% of the costs attributed to the Standard class, but it is not divided into in-office and street portions. We note, however, that constant marginal times seem inherent in the rural pay system. *See* Postal Service Response to VP/USPS-1, Doc. No. R2006-1, Jun. 27, 2006. The Postal Service should be asked to update this response and to explain how it should be used to analyze trends in the by-product costs for rural carriers.

seconds to 2.36 seconds, and were reasonably stable. Since 2008, however, the

marginal times have increased substantially.[18]

Graph 3, Standard Flats
City Carrier Street Time
Marginal Tme per Piece
2004=100
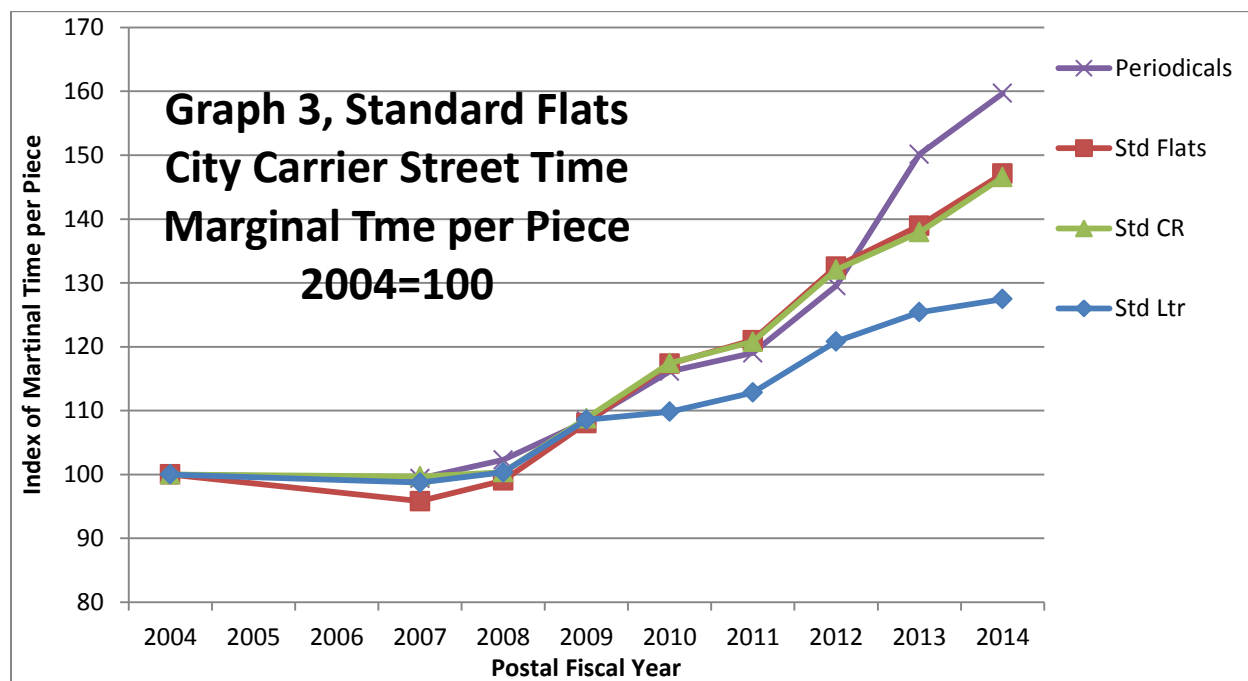
In index form, for 2004 to 2014, 2004 = 100, Graph 3 shows the marginal times

for four categories. The marginal time for Standard Letters increased 27.5%, and this

over a period in which letter volume increased 2.8%.[19] The marginal time for

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[18]   *See* tabs '7-Seg 7.1' and '12-Graph-3'.

        Table 4.3, p. 68, Op., Doc. No. R2005-1, shows a marginal time for flats that is equal to the marginal time shown for letters, each 1.4 seconds. The Commission states that USPS "witness Bradley emphasizes his belief that the estimates that result are reasonable from an operational standpoint" (p. 71). As discussed further in the text, we do not understand how the marginal time for letters grew to 2.57 seconds, an increase of 83.6%, and for flats to 3.66 seconds, an increase of 161.6%. We believe the Commission should ask the Postal Service to (a) present its reasoning and analysis supporting the marginal time of 1.4 seconds, for both letters and flats, (b) trace and discuss the reasons for the increases over time, and (c) present an MTM (or an MTM-like) analysis supporting the current results of 2.57 seconds and 3.66 seconds, with special attention to the relative levels.

[19]   Volume-increase figure includes all Standard volume that is delivery point sequenced, thus including Saturation. It does not include First-Class letters or cards.

Periodicals increased 59.7%, and for Standard Flats and Carrier Route about 47%. To get attributable costs, these marginal times are inflated by street support time and piggyback factors, and multiplied by volumes of up to 53 billion. The effect of these increases on costs, then, is very substantial.[20] To paraphrase Everett Dirksen: a billion seconds here, a billion seconds there, and suddenly you are talking about real money.

The question becomes: Why would it take an additional 3.7 seconds to handle an additional Periodical now, when it took only an additional 2.4 seconds in 2004? This is a large increase. The possibility of scale effects comes immediately to mind, particularly given the volume declines for flats. But this explanation has weaknesses.

It is true that delivery operations have fixed costs that are both understood and in a rough way identifiable.[21] It is also the case that delivery activities stand on the shoulders of these fixed costs, in a manner of speaking. But it is not the case that the Postal Service has made scale changes.

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[20]   To see the magnitude of a 59.7% increase in marginal time, consider a parcel delivery operation that delivers billions of parcels that found that the additional time to deliver an additional parcel had increased from 4 minutes to 6.4 minutes. There is no question but that a team of industrial engineers would be sent out, with all manner of lapse-time measurement devices, to find the reason for the increase.

[21]   In earlier analyses, for example, steps were taken to measure route time and access time. Route time is fixed and access time is fixed for stops already receiving mail. In the general case, however, it is not presumed that fixed costs can be identified and separately measured, and they generally cannot. If a working pool of 100 nearly identical employees costs $100 and handles 1,000 pieces of mail (averaging 10 cents per piece), its behavior could easily be that an additional piece costs an additional 8 cents. In postal parlance, the pool would be viewed as 80% variable and 20% fixed. But it would not be possible to single out 20 of the employees and label them as fixed. The fixed-cost figure is a measure of the fixity of the costs in the pool, in the face of a small volume change; it is not a group of costs that is fixed. The only empirical input to the total marginal cost, the volume variability, and the fixed cost is the marginal cost. They are reflections of it, which in turn is a reflection of the behavior of the pool.

Scale changes have to do with changing the nature of the productive operation in ways that are allowed by a different volume. Different techniques, different machines, different degrees of specialization and roundaboutness, and different work flows may be used. It may be a matter of using a bigger machine, with different geometry. Beam strength, for example, can vary with the cube of the height of the beam, changing design options substantially. An oil tanker designed to carry 550,000 deadweight metric tons (DWT) is thoroughly different from one designed to carry 50,000 DWT, even though the latter is in a category designated Large Range 1. From the drawing board up, a 550,000 DWT tanker is different.[22] It is not built by forming a train of eleven 50,000 DWT tankers or by strapping them together like a motorcycle with 10 side cars.

In its delivery system, the Postal Service has done <u>more or less of the same</u>. It has not changed its scale, although the management pyramid for a small-volume service might be smaller, and the network routing the mail to the carrier might be consolidated. Under these circumstances, with fixed costs that are understood, identifiable, and virtually separable (as opposed to being an inherent part of a productive mechanism) the default expectation can be for marginal costs to be approximately constant over a considerable range of volume.

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[22]   In a study of costing done for the Commission, "The Role of Costs for Postal Regulation" (c. Sept., 2014), John C. Panzar referred to the points on a long-run marginal cost curve as being "drawing board costs" (footnotes 4 and 6 particularly). The notion is that each point shows costs for a most-efficient plant built specifically to produce that level of output. Essentially, the firm hops from one point to the next, as new plants are built. But when, as here, the fixed costs are identifiable and would be the same in a larger-volume operation, the firm does not really change it scale. Rather, it simply does more or less of the same, and moving along a short-run marginal cost curve is essentially the same as moving along a long-run marginal cost curve. In any case, of course, the costs are efficiently incurred only if no excess capacity exists.

Once a marginal cost is estimated, at an operating point, it is easy to multiply it by the volume and obtain what William Baumol has called Total Marginal Cost, which can then be divided by total costs to obtain the variability percent. But this variability percent is valid only at that operating point. If the volume increased, the marginal cost would either increase, decrease, or remain the same. Then the new marginal cost would be multiplied by the new volume. The new variability percent would be this total divided by the new total cost, which would see a change of its own.

The question of how total costs change is important. With no change in scale, several steps of volume increase will result in several additions of marginal cost, and the change in the total cost will be equal simply to the sum of these additions. If the scale is changed and a new delivery system is built from the drawing board up, the new marginal cost must be found within the new system. But for carriers, the margin at a higher volume is very much the same as a margin at a lower volume, and a new system would have fixed costs (route time and nearly all access time) that are the same as the old system.

Basically, how the variability percent changes with volume is an empirical question. Evidence would be needed to support a particular relation. It cannot be presumed that the evidence would support a constant variability percent, constancy being only one of an infinite number of possible outcomes.

Evidence exists to support the marginal cost finding—it is the partial derivative of the cost-volume relation. Graph 3 shows substantial departures from the marginal cost findings. We believe an understanding of carrier operations would suggest that the marginal costs should be relatively constant over a wide range of volume. We see no

empirical support for presuming a constant percent variability. The behavior displayed

in the above graph suggests that that the street costs are invalid.

V. THE BEHAVIOR OF CITY CARRIER IN-OFFICE COSTS PER DELIVERED PIECE RAISES QUESTIONS ABOUT WHETHER THESE COSTS ARE BEING PROPERLY ATTRIBUTED. INQUIRY INTO THEM IS NEEDED.

The complement to city carrier street costs is in-office costs. These are viewed

as 100% variable with volume and are distributed based on tallies. Segment 6.1 is the

costs for direct casing activity. Although this cost is known, the number of pieces cased

is not.

Graph 4 shows the Segment 6.1 costs deflated by an index of carrier wage rates

and then divided by the number of pieces *delivered*.[23] If all delivered pieces were

Graph 4, Index of Segment 6.1 Deflated Cents per Piece, 2004=100

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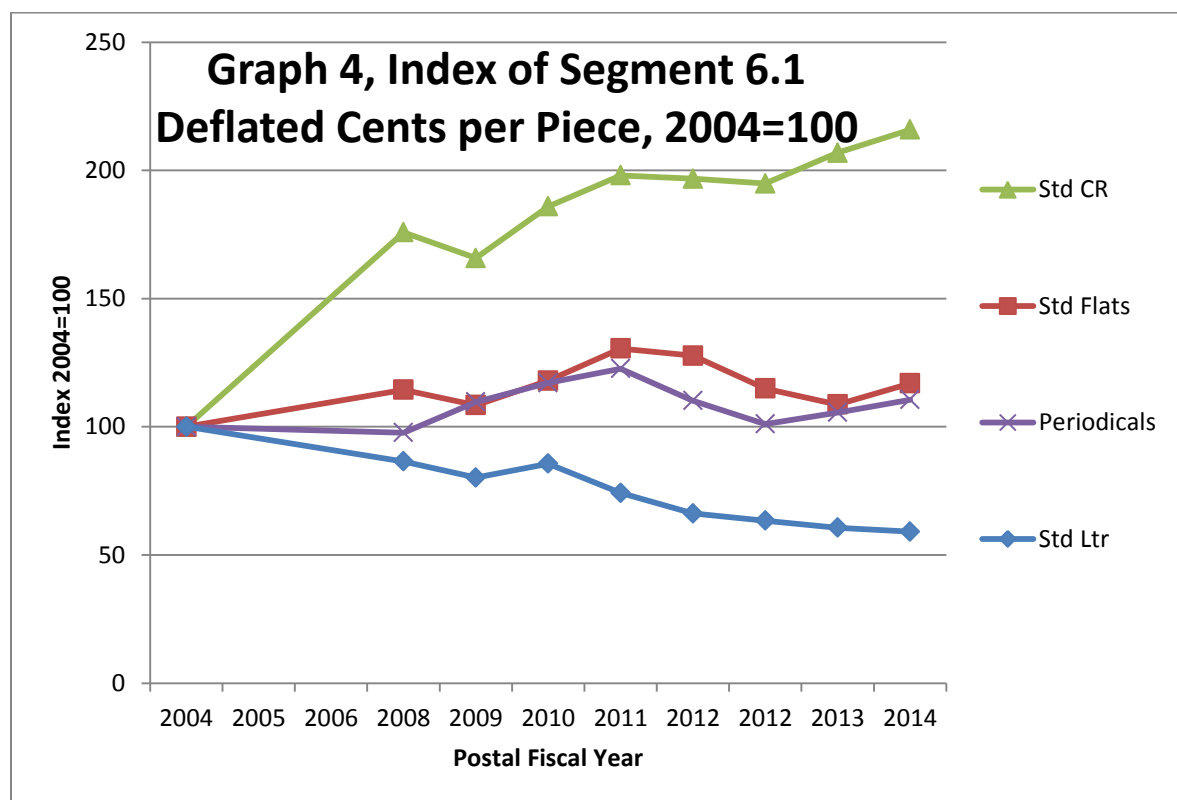
23   *See* tab '6-Seg 6.1'.

cased, these lines should be horizontal. But more and more of the pieces are being delivery point sequenced on machines, before getting to the carriers. When a piece moves from carrier to machine, the cost of casing should decline but the number of pieces delivered does not. With movement over time toward machine sequencing, then, these lines should decline as they do for Standard Letters.

As shown, the index for Standard Letters declined 40.9%, to an index value of 59.1. The proportion of Letters delivery point sequenced over this period went from 82.2% to 92.5% (*see* tab '2-Std Ltr'), an average that includes rural routes. If there are 10,000 pieces and 17.8% (1 - 82.2) are cased, then 1,780 pieces are cased. If the proportion cased declines to 7.5% (1 - 92.5), then 750 pieces are cased. Going from a workload of 1,780 down to a workload of 750 is a 57.9% reduction in workload. This makes the 40.9% reduction for Letters in the graph look like maybe it should be even larger.

The index for Standard Flats increased 30.6% by 2011, which seems unexplainable. Since 2011, a meaningful proportion of the pieces have moved to FSS processing. The index decreased a little in 2012 and 2013, but then increased significantly in 2014. The increase in 2014 is out of sync with the increase in mail processing costs discussed in Section III above. While it could take time for routes and office operations to adjust, but the cost is going in the wrong direction. This undoubtedly accounts in part for the reduction in cost coverage for Standard Flats. The behavior of the index for Periodicals is similar.

The most startling of the curves is for Carrier Route. Its deflated cost per piece increased 98.0% by 2011, and then continued to increase further to a total increase of

115.9% by 2014. The increases from 2011 to 2014 occurred while volume was shifting

to FSS processing, and one would expect more Carrier Route volume to shift than

Standard Flats volume. These results suggest misbehavior in in-office costing, and

attribution well above efficient levels.

VI. CONCLUSION.

If catalogers are to continue serving their customers, they need an efficient, low-

cost distribution system. Interest centers, then, on the postal rates for Commercial

catalogs. As explained in Section I, the cost coverage on these catalogs is an amount

in excess of 114.6%, a figure that was 106.5% in 2011 and has increased each year

since. If the Nonprofit categories are included, with their lower rates and

correspondingly lower coverages, the 114.6% declines to 105.2%, another figure that

has increased in recent years. We do not see that the rates for catalogs should be

viewed as out of compliance with the law. Certainly they cover their costs.

One category underlying these cost coverages is Standard Flats, which has

Commercial and Nonprofit components. The cost coverage reported for the

Commercial component is 90.6% (down 3.28 points in 2014), and for the Nonprofit

component is 53.4% (down 1.55 points in 2014). For both components together, the

coverage is 81.6% (down 3.29 points in 2014). These decreases occurred despite CPI

and exigency rate increases in January of the year.

Pre-FSS and still, Standard Flats has served two purposes: (1) it is suited to

small mailers who, for one reason or another, are not in co-mail pools, and (2) it is a

residual category for mailings that qualify in the main for Carrier Route. Co-mailing,

however, has become quite common, and bulk mailers today qualify as many pieces as possible for Carrier Route. Looking at the Commercial categories of each, Standard Flats was 51.2% of SF+CR in 2005, but only 31.9% of it in 2014. SF is the tail, not the dog.

Post-FSS, Standard Flats is serving an additional purpose, integral to all flats in the Standard class. With the changes proposed in Docket No. R2015-4 (and to an unknown extent in 2014 for FSS-prep flats that moved to 5-digit status and kept their CR rate), CR flats destinating in FSS zones must move (and HD flats may move) to the Standard Flats category and pay the FSS rates in the SF schedule for FSS Scheme (and Non-Scheme) Pallets/Containers. And we suspect that when these flats move, mailers will intermesh them with current SF volume, and that the CR and HD volume that moves will lose its identity. Under these circumstances, it would be counterproductive for the rates for Standard Flats to be forced higher in an attempt to bring about a higher cost coverage.

The Postal Service has managed the relation between the rates for Standard Flats and Carrier Route. We point out in Section I that the cost difference between them, as reported, is much larger than we believe can be rationalized. Partly for this reason, we believe, the rate difference between them has been smaller than the cost difference. ACMA understands that expanding the rate difference might increase the uniformity of the cost coverages as reported and cause them all to be over 100%, and that this might lower the rates for some of our members. But there are many other ramifications also. Thus, we believe at this time that the Postal Service should be given flexibility to manage this relationship.

All of the cost coverages discussed in this conclusion are those currently being reported. They are somewhat below the coverages indicative of the rates, because the last rate increase has been in effect for only about two-thirds of the year. In Sections II through V of these comments, however, we review a weighted cost index for several categories at issue, and look at the behavior over time of mail processing costs, city carrier street costs, and city carrier in-office costs. We provide a number of reasons for believing that these costs are not reliable. Under these conditions, on accepted costing principles, we believe the actual cost coverages may be considerably higher than the ones being reported, making our catalogs even more profitable than the cost coverage of 114.6% suggests. Above cap rate increases for Standard Flats mail would shackle efforts to develop FSS rates and would force additional volume out of the mail. Before this is done, the questions and inconsistencies addressed in these comments must be investigated and explained.

Respectfully submitted,

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